EXHIBIT A.521
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$728 million by the end of August 2002, equivalent to three to four years of public investment since the signing of the Oslo Accords. Destruction of private agricultural and commercial assets accounts for roughly half of this damage.

Principal Challenges and Critical Issues Confronting the Palestinian Economy

Once a final agreement creating an independent Palestine is reached, the new state will need to focus its energies on generating sustained economic growth. If an independent state is created, we expect that it will enjoy very substantial international attention and assistance. This said, the Palestinian economy will face a number of challenges and issues that will affect the economy's ability to generate sustained increases in output. Some of these challenges and issues derive from demographic trends, past economic activities, and the lasting effects of the second intifada. Others will result from the terms of the agreement itself, regarding the geographic shape and extent of the new state and economic and political arrangements. Below we discuss the major challenges confronting the Palestinian economy and identify critical issues for decisionmakers to consider with respect to final status negotiations.

Principal Challenges

Even after a final status agreement, the Palestinian economy will face a number of significant challenges. These include

- threats to security and political stability
- a growing labor force, much of which is currently unemployed
- underdeveloped economic sectors
- underdeveloped economic relations with Arab neighbors
- poor physical infrastructure
- limited private-sector access to capital
- immature governing institutions.

Threats to Security and Political Stability. Clearly, the most important issues affecting the development and growth of the Palestinian economy are security and political instability—particularly in regard to security issues between Israel and the Palestinian state. Economic markets abhor uncertain environments. Businesses and investors desire assurance that their investments will not be subject to unreasonable risk of destruction or expropriation. An environment of insecurity and political instability means that these agents will be less likely to invest, and that economic development and growth will suffer as a result. This sentiment is consistent with attitudes expressed by Palestinian businessmen in the World Business Environment Survey in 2000: Sev-

enty-seven percent of West Bank and Gaza respondents considered "policy instability and uncertainty arising from political conditions in the WBG [West Bank and Gaza]" a moderate or major constraint on expanding business operations and growth (Sewell, 2001, pp. 3–6).[11] In general, scholars of the region attribute the West Bank and Gaza's lackluster economic growth in the 1990s to the uncertain environment resulting from the interim nature of the Oslo Accords. The accords put off the resolution of major Palestinian-Israeli political disputes and failed to stop attacks on Israeli citizens and forestall the imposition of border closures and other severe security measures.[12]

For Palestine, achieving security and political stability depends on the ability of the Palestinian Authority and the Israeli government to craft a mutually beneficial final agreement that embodies effective security arrangements and governance solutions. (These topics are considered in depth elsewhere in this book, particularly Chapters Two and Three.) Overall, the absence of security will inevitably prevent sustained Palestinian economic growth by limiting employment opportunities and access to capital and inhibiting the free movement of people and goods that is necessary for economic success. In contrast, successful Palestinian economic development may help reinforce security and political stability as Palestinians focus their energies on commercial endeavors rather than on conflict with Israel.

Growing Labor Force. The most important asset of an independent Palestine will be its people. The West Bank and Gaza have a large and relatively well-educated labor force. A high percentage of Palestinians are university graduates and a majority of Palestinians speak English, a significant advantage in this age of globalization. In addition, the West Bank and Gaza can draw on members of the Palestinian diaspora, which is well positioned both in the Arab world and in Western countries, for international business contacts, capital, and commercial expertise.

The Palestinian economy of the 1990s, with its periods of high unemployment and lack of private-sector demand for well-educated labor, underutilized this asset. The capital investment necessary to complement an educated labor force was missing. There was also a mismatch between the skills of the Palestinian labor force and those most needed in modern economies. For example, the disproportionately small number of graduates specializing in the sciences and engineering as opposed to graduates specializing in humanities made it more difficult to find jobs for all college graduates.[13]

The Palestinian labor force is projected to rise from 625,000 in 2000 to over 960,000 in 2010—an average annual increase of 5.4 percent. This growth will be even higher if substantial numbers of Palestinian refugees immigrate to the West Bank and

[11] Following policy instability and uncertainty as a constraint were corruption (71 percent), inflation (64 percent), the exchange rate (62 percent), taxes and regulations (56 percent), and anti-competitive practices (54 percent).

[12] For more information see Shikaki (2002), Naqib (2002), and World Bank (2002b).

[13] Chapter Eight, Education, expands on this topic.

Gaza and if the currently low rate of labor force participation by Palestinian women increases by more than expected [International Monetary Fund (IMF), 2001].[14] Demand for labor in the Palestinian state will have to grow rapidly over the next 10 to 15 years to accommodate these workers if the state is to avoid widespread unemployment and reduce poverty. This will not be an easy task. Historically, the domestic economy has struggled to provide adequate jobs, even during periods of substantial Palestinian employment in Israel.

Underdeveloped Economic Sectors. A number of important economic sectors in the West Bank and Gaza are underdeveloped. Manufacturing, for example, is relatively small in terms of employment, share of GDP, and exports. The most important manufactured goods in the West Bank and Gaza are footwear, leather goods, apparel, generic pharmaceuticals, furniture, plastics, and wood and metal products. Exported goods consist mostly of unsophisticated, labor-intensive manufactures. For example, the most important export is quarried construction materials. The small volume of exports from the West Bank and Gaza and the relatively limited array of exported goods suggest that Palestinian products are not very competitive on international or domestic markets.

The private sector in the West Bank and Gaza is dominated by small enterprises.[15] These tend to be companies working under subcontracting agreements with Israel, or family businesses that often depend on unpaid family labor. Palestinian agriculture remains very labor intensive. It utilizes few of the agro-technological advances that benefit Israeli agriculture. It serves as the employer of last resort, particularly during times of economic disruption.

Inter-industry linkages, such as among agriculture, agricultural supply industries, and food processing, are very poor in the West Bank and Gaza. Consequently they have inhibited the growth of clusters of integrated industries that would be beneficial for generating economies of scale and scope. Weak inter-industry linkages stem from several causes, including the physical separation of the West Bank and Gaza, historical restrictions by Israel on Palestinian industrial development, and (particularly since the start of the second intifada) limited mobility of goods and people within the West Bank. The result is low domestic value added—products are either exported as raw materials or Palestinian businesses add little value to imported components or raw materials. The low levels of value added by domestic businesses limit the benefits derived from free trade agreements, which often demand that exported goods contain substantial shares of local content.

Consequently, current production patterns are not a good reflection of Palestine's comparative advantage as an independent country. However, current economic activi-

[14] This IMF estimate assumes no net migration and that female participation in the workforce remains relatively low but increases from about 11 percent in 1999 to about 24 percent in 2025 (the current level in Jordan).

[15] In 1999, the number of companies employing more than 100 employees was less than 1 percent of the total number of registered companies operating in Palestine, while companies employing less than 20 employees constituted almost 99 percent (Muhanna and Baker, 2001).

ties cannot simply be discarded or radically altered with the promise of a better future because they are the only sectors currently providing employment and business opportunities.

Underdeveloped Economic Relations with Arab Neighbors. As a small and developing country, an independent Palestine would benefit greatly from strong economic ties with other countries, particularly its Arab neighbors, to diversify its trading relationships and spur economic growth. Strong economic relations with Arab countries could facilitate the flow of additional capital into Palestine for expanding current businesses and financing new ventures. Arab investments could also provide additional employment opportunities in the region for Palestinian labor. Such relations are particularly important because they would facilitate more Palestinian trade, increase the number of sources of Palestinian imports, and provide markets for Palestinian exports.

Current economic ties with the West Bank and Gaza's Arab neighbors are weak. In 1998, the West Bank and Gaza's immediate Arab neighbors, Jordan and Egypt, together accounted for only 3.4 percent of the value of merchandise trade transactions (exports plus imports) with Palestinians [United Nations Office of the Special Coordinator in the Occupied Territories (UNSCO), 2000, p. 29]. Although Jordan is the West Bank and Gaza's second-largest trading partner, in absolute terms the volume of trade with Jordan remains small. Despite having signed a trade agreement with the West Bank and Gaza, Jordan has introduced obstacles to trade such as high duties on Palestinian exports and excessive administrative requirements for exporting and importing goods across Jordan's border.[16] As for Egypt, the West Bank and Gaza's ninth-largest trading partner, trade between Egypt and the West Bank and Gaza has been minimal, consisting primarily of imports of Egyptian food and consumer products into Gaza.

There are a number of reasons for weak economic ties between Palestinians and Arab countries: The transportation infrastructure necessary for direct trade (i.e., roads, airports, seaports, and pipelines) is inadequate; Israeli security measures increase the costs of trading with other countries; many Arab countries have high trade barriers, imposing a large number of cumbersome regulations, and have boycotted Israeli (and thus Palestinian) goods; and many Palestinian products are not competitive in low- and middle-income countries because of the West Bank and Gaza's high costs for energy and unskilled labor.

Palestine, Israel, and the international community can mitigate some of these negative factors during final status negotiations. But even if most or all of these issues can be satisfactorily resolved and ties with Arab neighbors strengthened, the overall economic impact could still be quite small. Jordan would be unlikely to absorb a large

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[16] For example, a truckload of stones imported into Jordan from the West Bank and Gaza would incur a duty of 180 dinar (about $270), which has had the effect in the latter half of 1990s of limiting the importation of stones, a competitive Palestinian product. Soap, another potentially competitive product, has also incurred high duties. Jordan also required Palestinian truck drivers involved in trade to carry Jordanian passports, driver's licenses, and registrations (UNCTAD, 1998).

number of Palestinian exports or workers, considering that its economy is one-tenth the size of Israel's and has similar circumstances to those in the West Bank and Gaza (i.e., few natural resources and a labor force with many low-skilled workers). The larger Egyptian market would presumably present more opportunities, although its low per-capita income levels would permit only modest amounts of Palestinian exports, and high Egyptian unemployment levels would suggest few employment opportunities for foreigners. Rich Gulf countries like Saudi Arabia represent potentially larger markets for Palestinian exports, but they also tend to have rather closed economies.

Poor Physical Infrastructure. Sustained growth in Palestinian per-capita incomes will require a physical infrastructure capable of supporting provision of basic services, developing profitable industries, and transporting goods and people. Such infrastructure includes roads, bridges, and transportation hubs such as seaports or airports for travel and trade within Palestine and with its neighbors and the rest of the world. Palestine needs power plants and electricity grids as well as water and sewage systems that serve both homes and businesses. Palestine also needs a modern telecommunications network, especially to facilitate the development of high-technology sectors, commerce, and tourism.

Palestinian physical infrastructure needs considerable improvement. Existing Palestinian infrastructure has been damaged by military operations during the second intifada and depreciated as a consequence of the economic environment and mobility restrictions (UNCTAD, 2002, p. 4). But even before the intifada, Palestinian infrastructure was in worse shape than in some countries with similar per-capita incomes, despite significant donor assistance. The hilly topography of the West Bank and Gaza and the construction of Israeli settlements and settlement roads have inhibited the development of an adequate Palestinian road network linking population and trade centers. The Palestinian economy depends heavily on Israeli seaports and airports for transport and travel with the rest of the world. The West Bank has no airport and Gaza has one, but Israel closed the airport in 2000 and destroyed the runway in 2002; in any case, the Gaza airport has never had cargo facilities. The construction of an international seaport in Gaza has been put on hold, and the roads and bridges connecting the West Bank to Jordan and Gaza to Egypt are in poor condition.

The Palestinian economy now relies primarily on Israel for electricity. The electricity distribution grid is in poor condition, resulting in substantial electricity losses. These conditions contribute to the West Bank and Gaza having the lowest per-capita energy consumption in the region and the highest electricity costs. Palestinian water quality is declining (as described in detail in Chapter Six). There are no modern sanitary landfills, and sewage systems are rudimentary. Many communities have open sewers.

Introduction of the domestic telecommunications provider PALTEL helped to speed development of that sector. The number of telephone lines more than tripled between 1997 and 2000 (MAS, 2001). Even so, PALTEL is currently prevented by Israel

from developing its own international communication services. As of 2000, there were nine Internet providers in the West Bank and Gaza, serving only 60,000 users.

Limited Private-Sector Access to Capital. Significant capital would likely be made available to assist Palestine once it gains independence. Palestinians currently receive substantial financial assistance from outside countries and organizations such as the World Bank; we expect this assistance to continue in the future. Other sources of capital include the Palestinian diaspora and foreign direct investment through multinational corporations.

An important question is how much of this capital can be accessed by individual businesses seeking to expand and modernize their facilities. The Palestinian financial sector expanded rapidly during the 1990s, attracting almost $3 billion in deposits by 2000. But small enterprises, which dominate the Palestinian economy, had trouble obtaining commercial loans and other financing. The lending-to-deposit ratio was very low; most loans went to state-owned firms and commerce. Long-term loans to finance investment in manufacturing were particularly scarce.

The World Bank notes that the lack of private-sector access to capital is in part the result of the absence of a supportive legal framework and regulatory institutions, as well as the uncertain political and economic environment.[17] The West Bank and Gaza lack the legal framework and supporting institutions necessary to establish and enforce property rights. Regulatory institutions lack mechanisms such as auditing and accounting standards to assess and mitigate risk.

As a result of these conditions, the Palestinian banking sector is highly risk averse: Banks remain relatively liquid, making only short-term loans. Both borrowers and lenders deposit excess liquidity abroad because of the limited number of safe investment opportunities domestically. The deficiencies of the legal framework have caused banks to adopt strict lending requirements such as high collateral and traditional forms of security such as cash, personal guarantors, and real property with clearly held titles—a rarity in the West Bank and Gaza for political and historical reasons. Most business assets such as working capital, equipment, and vehicles as well as immovable assets are unacceptable to banks as collateral because they tend to be unregistered and as such cannot be readily seized.

Immature Governing Institutions. Governing institutions determine the rules by which a country's economic activities take place. A strong system of governing institutions is needed to support business transactions. These institutions create enforceable property rights, provide businesses with transparent information on taxation and registration, and issue clearly defined rules and regulations. These elements help minimize uncertainty and limit political and economic corruption. By so doing, they help to encourage economic activity.

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[17] For example, in 1999 there was a financial-sector development project proposed by the World Bank (1999c).

Important government institutions in the West Bank and Gaza such as the judiciary are currently weak. To some extent, the weakness of these institutions has impeded economic development. For example, in 1998 the Palestinian Legislative Council approved a law establishing a judiciary independent from the executive branch, a highly progressive move for the Arab world, but the PA did not enact this law until May 2002. The PA's willingness to faithfully implement the law remains unclear (Brown, 2002, pp. 29–31). The existence of special security and military courts continues to threaten the effectiveness of the judiciary by encouraging Palestinians to resolve disputes through means other than the civil courts. The PA has yet to enact a number of laws that would strengthen the enforcement of private contracts and commercial activity, including the Company Law, the Intellectual Property Law, the Secured Lending and Leasing Law, and the International Commercial Arbitration Law (Sewell, 2001, pp. 16–18).

The lack of accounting and auditing standards, as well as the lack of experience on the part of the Palestinian Monetary Authority in regulating and supervising banks, has adversely affected lending. The lack of oversight of PA commercial operations coupled with excessive PA hiring and spending suggest to businesses that the executive branch is neither transparent nor accountable for its actions. At the same time, simply passing laws and creating institutions does not necessarily ensure good governance. The government of a Palestinian state will also need to develop personnel procedures and introduce rewards and penalties that will encourage effective governance. (For more detail on the development of Palestinian governance, please see Chapter Two.)

Critical Issues

The previous discussion highlighted some of the challenges facing the development of a viable economy in a Palestinian state. While addressing these challenges, decisionmakers must consider the critical issues that are relevant to any negotiated final agreement and that markedly affect the path and prospects for Palestinian economic development and growth. These critical issues are

- transaction costs
- resources
- the Palestinian trade regime
- Palestinian employment in Israel.

Transaction Costs. Many of the measures that Israel implemented since the 1990s to prevent violence and maintain security have severely impeded the economic activity in the West Bank and Gaza by imposing very large additional transaction costs on business activities. The complex and cumbersome system of permits, fees, security checks, and special transportation procedures has constrained the movement of both goods and people. For example, regulations that require Palestinian haulers to completely unload their cargo and reload it onto Israeli trucks at the border for passage through Israel have added significant transaction costs to Palestinian commerce because of delays and addi-

tional shipping expenses. Closures between the West Bank, Gaza, and Israel have made the movement of goods and people very difficult. A study in 1998 before the second intifada by the Federation of Palestinian Chambers of Commerce, Industry and Agriculture estimates that transaction costs were, on average, 30 percent higher for Palestinian companies than for Israeli companies, and time delays were 45 percent longer (IMF, 2001, p. 73). Not only do these transaction costs make Palestinian goods more expensive (and thus less competitive), they also adversely affect Palestinian industrial supply relationships because of increased risk and uncertainty faced by customers and suppliers.[18]

The physical separation between the West Bank and Gaza and the existence of Israeli settlements in the West Bank and Gaza also result in high transaction costs. Settlements and the network of bypass roads increase travel time within the West Bank and Gaza, especially during periods of Israeli closures. The necessity of passing through Israeli territory to travel between the West Bank and Gaza interrupts the movement of goods and people and increases costs. Also, major travel routes connecting the southern and northern halves of the West Bank pass through Jerusalem, so Israeli security measures for Jerusalem can affect transportation throughout the West Bank. Duplicative layers of bureaucracy impose additional costs as Palestinian companies seek operational approvals from both the PA and the Israeli government.

A Palestinian state that is allocated more territory in the West Bank and Gaza and more sovereignty over this territory would face lower transportation and transaction costs than a more fragmented entity. Dismantling some Israeli settlements, easing or providing access to settlement roads, removing checkpoints, and generally increasing the contiguous nature of Palestinian lands would reduce travel and transaction costs, thereby spurring economic activity.

Resources. The West Bank and Gaza have very few natural resources of commercial value. Current commercial resources are limited to potash, which is used in the production of fertilizer, and quality limestone, marble, sand, and gravel, which are used in the construction industry. Newly discovered (and hence undeveloped) natural gas deposits off the coast of Gaza may be commercially viable, but currently the West Bank and Gaza have no fossil fuel resources; the only potential sources of energy available domestically are solar power and limited hydropower. Palestinian access to clean water is an issue. Although the West Bank borders the Jordan River and sits atop a sizable underground aquifer, these water resources are nearing the point of complete utilization by the West Bank, Gaza, Jordan, and Israel.[19] The West Bank and Gaza do have a favorable climate for agriculture: Crops can be grown year-round. Despite its small size, Palestine offers seven agro-climatic zones with at least 20 different soils supporting about 60 different crops. In addition, major cultural sites are located in Bethlehem, Jericho, and East Jerusalem, while the Dead Sea and the Mediterranean coast offer the potential for recreational tourism.

[18] For more details on transaction costs see IMF (2001, pp. 61–82).

[19] See Chapter Six, Water, for more-detailed information.

Broadly speaking, more control of resources and rights would provide Palestine more options for developing its economy. A Palestinian state with more cultural sites could develop a more extensive tourism sector. A Palestine with more water rights in the Jordan River valley could expand agriculture and other industries. And a Palestine with control over its airspace would have the option of building its own airport to transport people and cargo instead of relying on regional facilities. By the same token, one could imagine that a Palestine with little control over its resources would find it much more difficult to develop industry and agriculture.

The Palestinian Trade Regime. Upon achieving statehood, a Palestinian government will need to negotiate trade agreements with its immediate neighbors (Israel, Jordan, and Egypt), with its other Arab neighbors, and with other important partners such as the United States and the European Union. Decisions on the trade regime will have major consequences for future economic development. If the West Bank and Gaza continue to receive preferential trade access to Israel, Palestinian exporters will benefit from the large, proximate Israeli market. Many existing Palestinian firms have contracting and subcontracting relationships with Israeli companies, providing a further reason for seeking to maintain preferential trade relations. If preferential access is discontinued, West Bank and Gaza exporters will have to find new markets.

Because of the current Israeli-Palestinian *customs union* (described above), Palestinian and Israeli goods have free access to each other's markets, common tariffs on other countries' goods, and the same trade policies with respect to external partners. Maintaining a customs union with Israel has some advantages. It would minimize administrative and customs costs because Israeli customs offices would continue to collect and reimburse tariffs on Palestinian imports transiting Israeli ports. It could also strengthen industrial supply relationships between the two countries.

However, maintaining a customs union would also have some disadvantages. It would leave Palestine highly vulnerable to shocks in the Israeli economy and to political relations with Israel. The tariff structure of the union would likely reflect Israeli interests more than Palestinian interests, potentially impeding the development of competitive Palestinian sectors. A future Palestinian state could also lose tax revenues through leakage to Israel of import duties and value-added taxes as is currently the case. If continued close trade links with Israel come at the price of barriers to trade with other potential partners, a future Palestinian government might seek more open trade relations with other partners.

Alternatively, a future Palestinian state may choose to negotiate *free trade agreements* with a number of states, including Israel. Under such a trade regime, Palestine would impose no tariffs on imported goods from all of its trading partners with which it has free trade agreements, including Israel.[20] This would provide Palestine the op-

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[20] Another possible trade regime would be a *nondiscriminatory trade regime*, under which Palestine would control its own tariff structure and regulations while treating all trading partners equally. The difference here is that Palestine might set nonzero tariffs for different goods. Given the economy's small size and the need to generate as much economic activity as possible, nonzero tariffs would not be recommended. Consequently we do not consider this option in our analysis.

portunity to strengthen ties with other countries in the Middle East, North America, Europe, and Asia, diversifying its exports markets and sources of supply. If Palestine were to eliminate all or most tariffs, which act as a tax on commerce, it would reduce administrative costs since an extensive customs apparatus would not be needed. A completely free trade regime would help Palestine foster use of its comparative advantage in labor, accelerating economic growth.

If Israel were to decide not to provide a future Palestinian state duty-free access to the Israeli market, growth in Palestinian exports would be retarded by the additional costs imposed by Israeli tariffs on Palestinian exports. The reduction in trade could adversely affect Palestinian economic growth in light of Palestine's underdeveloped economic relations with the rest of the world and its lack of transport infrastructure.

Palestinian Employment in Israel. For decades, relatively open Israeli labor markets have allowed Palestinian workers to commute to jobs in Israel and the settlements and return to their homes in the West Bank and Gaza at night.[21] The extent of Palestinian access to employment in Israel and the specifics surrounding this access (e.g., system of permits and lack of access during border closures) will need to be determined in any final agreement.

Easy Palestinian access to the Israeli labor market (in terms of legally sanctioned access either with or without permits) would provide significant employment opportunities for the Palestinian workforce. As we have described, the domestic economy has had difficulty providing full employment for Palestine's current workforce; the IMF projects that the labor force will grow by 40 percent by 2010 (even assuming no influx of refugees). Israel could offer significant additional opportunities for employment. Wages in Israel tend to be substantially higher than those in the West Bank and Gaza, boosting Palestinian incomes. Higher Palestinian incomes translate into higher expenditures, which would fuel the domestic economy.

The primary constraint on Palestinian employment in Israel is security. The Israeli government wishes to ensure that no Palestinian workers in Israel engage in attacks on Israelis. In addition, the Israeli government has frequently used closure of borders or closure of Palestinian towns and cities as a means of combating attacks. Closures make it virtually impossible for Israeli firms to hire Palestinians because employers can never be sure that their employees will be able to make it to work. For Israeli firms to be willing to hire a significant number of Palestinians, Palestinians would have to have relatively unfettered access across Israeli borders. Future Israeli governments may conclude that the security risks of permitting large numbers of Palestinians to work in Israel are so large that the past practice of permitting Israeli firms to employ Palestinian labor is unacceptable. Such a decision would deprive Palestine of this source of employment and income.

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[21] Beginning in the early 1990s, Israel began requiring Palestinians working in Israel and the settlements to obtain permits as a condition of employment. Also, it is currently illegal for Palestinian workers to remain overnight in Israel.

Economic Scenarios for a Future Palestinian State

The Palestinian economy could develop and grow along very different paths, depending on the conditions that international decisionmakers specify in any final agreement and decisions made by policymakers in the new state. Four critical issues—transaction costs, resources, the Palestinian trade regime, and Palestinian employment in Israel—will shape the conditions under which economic activity occurs in an independent Palestine. In this section we use these issues to construct four scenarios of conditions that Palestine could face with respect to its economic development.[22]

Scenarios of Economic Development

Other studies have examined prospects for economic growth in a newly established Palestinian state. A study by the World Bank (2002c) examines how the Palestinian economy might develop under different scenarios of economic and political relations with Israel, including various trade regimes and degrees of access of Palestinian labor to employment in Israel. The study uses a comprehensive macroeconomic model that incorporates foreign trade and labor markets in addition to growth accounting, providing projections for 2002–2010. A study by the IMF (2001) uses a growth accounting framework to generate economic projections up to 2010, based on different assumptions about access to the Israeli labor market and immigration. The study makes some reasonable assumptions about employment growth, predicts unemployment rates for 2010, and computes the increases in total factor productivity (TFP) needed to achieve acceptable levels of per-capita income.

Our analysis combines these two approaches. Like the World Bank study, we develop plausible scenarios based on the territory encompassed by a new Palestinian state (geographic contiguity) and its economic relations with Israel (economic integration). We discuss these scenarios qualitatively below. Like the IMF study, we use a simple growth-accounting model to project the growth in per-capita GDP and GNI under each scenario for the 2005–2019 time frame based on estimates of growth in employment, TFP, and capital. This quantitative analysis is presented in the next section.

Two points should be made at the outset of our discussion. First, we substantially simplify real-world conditions in our analysis. As the preceding sections suggest, many different policy and investment decisions will shape the future of Palestinian economic development. However, some simplification is necessary to focus on the major drivers of economic development in Palestine and to allow for clear inferences to be drawn. We, therefore, concentrate on the effects of contiguity and integration in the following section but recognize that many other factors, such as the quality of governing institutions, will play important roles also.

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[22] This is not to suggest that the initial conditions are necessarily fixed in stone. Allocations of rights and institutional arrangements can always be renegotiated in the future should parties deem it beneficial.

Second, we implicitly assume that security is maintained throughout the 2005 to 2019 time frame. In other words, our scenarios are predicated on the notion that economic activity occurs in a safe and stable environment. Lack of security, and resulting responses to it, would inhibit all aspects of Palestinian economic development described in this chapter. Consequently, our conclusions are correctly seen as what might happen in the best case.

Geographic Contiguity

A major determinant of transportation and transaction costs that a Palestinian state will face and the resources that will be available to it will be *geographic contiguity.* We define geographic contiguity broadly to include the amount of territory allocated to the Palestinian state, special sites (such as East Jerusalem and the Jordan valley), the integrity or fragmentation of this territory (perhaps because of settlement roads), and control over elements associated with this territory such as water rights, airspace, and borders.

We consider two possibilities on the geographic contiguity dimension. The *low-contiguity* case reflects conditions that are similar to but still an improvement over the period since the signing of the Oslo Accords. It assumes that for the most part, Israel retains control over East Jerusalem, the existing settlements, aquifers and surface water in the West Bank, external borders, and the customs apparatus. However, Israel would have less authority over the internal situation in the Palestinian state: It could not impose internal closures or curfews or prevent Palestinians from developing their own infrastructure (e.g., water, power, and transportation) should they choose to do so.[23]

The *high-contiguity* case assumes that the Palestinians have (1) more land (e.g., the Jordan valley and the Dead Sea coast), (2) more control over East Jerusalem, (3) more water rights and territorial control, and (4) unfettered passage between the West Bank and Gaza. This case also assumes that most settlements are dismantled or exchanged for contiguous land elsewhere.

Economic Integration

We use an additional composite dimension called *economic integration* with Israel that encompasses the Palestinian trade regime and Palestinian access to Israeli labor markets. In the sense used here, economic integration is similar to "border permeability" or "border openness" used elsewhere in this book.

We consider two possible cases. Under *high economic integration,* cross-border commerce resembles that which existed under the Oslo Accords. This case assumes a customs union (or perhaps a free trade agreement) between Palestine and Israel, a large number of Palestinians are allowed to work in Israel (likely around the pre-intifada

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[23] Given that the low-contiguity case in our analysis reflects an improvement over the status quo (from the Palestinian perspective), any final agreement that encompasses less land or fewer resources than the low-contiguity case—or that entails limitations on movement of goods and people within Palestinian territory, via closure or curfew—presumably would make it more difficult to sustain economic growth than our analysis suggests.

level of 130,000), and transit and travel procedures in both directions are simple for people and goods.

Under *low economic integration,* cross-border commerce with Israel is impeded by a symbolic or physical wall. This case also assumes that the current customs union with Israel ends and Palestinian businesses do not have favorable access to Israeli markets; that barriers to labor mobility significantly reduce the number of Palestinians working in Israel; and that restrictions are imposed on tourists and others wishing to cross the border. Under both cases, Israel remains an important trading partner, but conditions under high economic integration are more conducive to economic cooperation between Palestine and Israel, providing the possibility of higher trade volumes, more cross-border investment, and more collaboration in tourism and other sectors than in the low economic integration case.

Four Scenarios

The degree of geographic contiguity determines how much control Palestinians will have over resources and movements of people and goods within the new state. The degree of economic integration captures future economic relations between the Palestinian state and Israel. Together, these dimensions create a simple two-by-two framework describing initial conditions confronting the Palestinian state. The likelihood of ending up in any of the four quadrants will vary depending on negotiations to establish the new state and the strategic choices made. It is also possible that the new state could be in more than one quadrant in the first ten years of its existence. This section presents these scenarios without delving into their likelihood, but these issues are discussed in some detail in Chapters Two and Three. As is clear below, there are real consequences to the degree of contiguity and integration of the new state.

As shown in Figure 5.1, these dimensions yield four potential starting points or scenarios for the development of the Palestinian economy and the initial conditions with which the state—with the assistance of external parties—will have to contend. These scenarios are (1) high contiguity/high integration, (2) high contiguity/low integration, (3) low contiguity/high integration, and (4) low contiguity/low integration.

Scenario One: High Contiguity/High Integration. In the first scenario, Palestine consists of a contiguous West Bank with an uninterrupted road and rail link to Gaza. Palestinian territory on the West Bank encompasses significant cultural sites. Palestine has rights to aquifers and other sources of water on its territory. Consequently, transport and transaction costs for businesses and consumers are relatively low. Citizens can move freely within the state and travel to and from Jordan and Israel without much cost or delay. In this scenario, very substantial numbers of Palestinians are permitted to work in Israel, similar to pre-intifada days. Palestine and Israel sign a free trade agreement or agree to continue the customs union.

Figure 5.1
Four Scenarios of Palestinian Economic Development

Geographic contiguity \ Economic integration with Israel	High	Low
High	Lower transaction costs More land and resources Preferential trade with Israel Many workers in Israel	Lower transaction costs More land and resources No preferential trade with Israel Few workers in Israel
Low	Higher transaction costs Less land and fewer resources Preferential trade with Israel Many workers in Israel	Higher transaction costs Less land and fewer resources No preferential trade with Israel Few workers in Israel

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High contiguity would give Palestinians more options for economic development. Control over major cultural sites would allow Palestinians to collaborate with Israel in attracting and catering to tourists from abroad. Control of the airspace over Palestine would permit Palestinians to choose between constructing their own air cargo facilities or using Israeli airports. Access to higher-paying jobs in Israel would reduce underemployment in Palestine and help to create sustained increases in per-capita incomes; pre-intifada per-capita income levels would return fairly quickly.

Under this scenario, Palestinian employment in Israel rapidly returns to its pre-intifada level. Within Palestine proper, employment growth is concentrated in tourism, construction, and light manufacturing, much of which would consist of subcontracts from Israeli firms. Indigenous economic activity would be skewed toward retailing and wholesaling, transport, agriculture, and the manufacture of labor-intensive consumer goods. Economic activity within Palestine would be bolstered by preferential access to Israeli markets, resulting in a ready supply of inputs and nearby markets for exports and the option of using Israeli seaports, airports, and infrastructure to reach other markets.

Scenario Two: High Contiguity/Low Integration. As in the first scenario, Palestine has significant land and resource rights and goods and people circulate freely in Palestine. The primary difference in this scenario is that economic links with Israel are attenuated. Although Palestinian businesses are able to export to Israel, access to Israeli markets are no better than to other countries or regions with which Palestine has free trade agreements or faces reduced barriers to trade. Palestinian workers, however, have little or no access to the Israeli labor market. Under this scenario, the Palestinian

economy could still grow fairly rapidly, but GNI would be appreciably lower than in the first scenario because of the absence of worker remittances from Israel.

In the short term, agricultural production, the manufacture of labor-intensive consumer goods, and services would likely provide most employment and account for most economic output. Palestinian control over natural resources, especially water, would facilitate increases in domestic food production and the emergence of high-value horticultural exports, such as fresh-cut flowers. Agriculture and tourism, which are labor intensive, would help to absorb the thousands of low-skilled laborers no longer able to work in Israel. That said, the domestic economy, at least in the short term, would probably be too small to accommodate the entire Palestinian labor force, considering that roughly 20 percent of it once worked in Israel.

Economic growth would rely largely on the growth of Palestinian exports. Having no tariffs and low transaction costs would help facilitate manufacturers' access to inexpensive inputs, but because Palestinian exports to Israel would now be subject to tariffs (de facto price increases), trade between the two countries would grow more slowly than in the first scenario. Palestinian exporters would have to find new markets in the Middle East, the European Union, and the United States. Export growth would require better infrastructure and unfettered access to a Gaza seaport or to airports capable of handling significant amounts of cargo. Until this infrastructure is completed, increases in per-capita GNI would likely be modest.[24]

Scenario Three: Low Contiguity/High Integration. In the third scenario, Palestine is not contiguous but it is highly integrated into the Israeli economy. In this scenario Palestine will have the ability to leverage Israeli facilities, but construction of infrastructure would still be important to reduce transport times and transaction costs and to improve the environment for economic growth. Within the domestic economy, services such as tourism and retail and wholesale trade would be major employers. The Palestinian economy would also benefit from the wages earned by Palestinian workers in Israel and with Palestinian employment from subcontracting in Palestine. Because of the lack of control over water, the agricultural sector would likely languish. However, there would be opportunities for Palestine and Israel to collaborate on fostering tourism.

The lack of resources and the reinforcement of traditional economic relationships between Palestine and Israel could possibly limit the potential of Palestinian economic development. However, this need not be the case. Presumably, as long as the Israeli economy grows steadily and both Israel and Palestine make a concerted effort to expand trade with other countries, Palestine would be able to sustain economic growth. There would, however, be very high transaction costs to overcome as a result of the

[24] We note that factors that may lead to low economic integration with Israel—particularly Israeli concerns about security—are also likely to inhibit the unfettered passage of people and goods between the West Bank and Gaza that we consider to be part of "high contiguity."

lack of contiguity because Palestinian goods and people would have to cross multiple borders. Among other outcomes, this would make Palestinian-produced goods more costly and less competitive on world markets.

Scenario Four: Low Contiguity/Low Integration. Scenario four is characterized both by limited geographic contiguity and by economic separation from Israel. This scenario assumes that the number of Palestinians permitted to work in Israel is severely constrained. Consequently, the Palestinian government would be confronted with the problems of finding employment for the vast majority of Palestinian workers. The absence of major cultural sites or adequate water supply as well as higher transaction costs would adversely affect the state's ability to develop domestic tourism or agriculture.

The scenario also assumes that Palestine would not have preferential access to the Israeli market, so the importance of Israel as an export market and source of imports would decline. Economic activity in the short term would likely center on services, construction (particularly of infrastructure), and efforts to industrialize. Domestic industries in this scenario would develop slowly; it is unlikely that they would grow rapidly enough to accommodate the growing Palestinian workforce. Even if donors funded large-scale construction projects that would employ large numbers of Palestinians workers, it is doubtful that there would be a sufficient number of domestic jobs to significantly cut into unemployment. Growth in per-capita incomes would be slow or stagnant. Foreign donors would probably need to fund significant social welfare programs to feed and cloth large numbers of Palestinians. This scenario is the least favorable for a new Palestinian state: Economic development would likely be stunted and growth in per-capita incomes slower than in the other scenarios.

Even faced with these unfavorable conditions, Palestine might be able to generate appreciable economic growth if the international community were to finance the infrastructure necessary to reduce transportation and transaction costs and create a more favorable environment for business. Ideally, donor-funded projects would attract enough foreign direct investment to spur growth. In particular, Palestine would need a comprehensive network of surfaced roads, a seaport, a modern telecommunications system, and the right to use them. These would be necessary for the efficient movement of people and goods, including imports and exports. At the same time, we emphasize that considerable additional investment would be necessary to help compensate for unfavorable conditions of contiguity and integration, and that even then there would be no guarantee that the economy could overcome the considerable hurdles this scenario would present for achieving sustained economic development.

Summary of Implications

This framework of four scenarios is simply a tool to help decisionmakers consider the consequences of the different forms a final agreement could take. The scenarios illustrate the starting conditions for Palestinian economic development resulting from the specific circumstances negotiated in a final agreement. Each scenario has different im-

plications for Palestinian economic development and the growth of per-capita incomes that can be sustained.[25]

We summarize below the qualitative implications of the four potential scenarios, given their assumptions regarding geographic contiguity and economic integration with Israel:

High-contiguity/high-integration scenario yields rapid economic growth:

- Lower transaction costs and Palestinian control over land and resources result in broad economic development.
- Economic cooperation with Israel provides access to Israel's relatively large market for exports, facilitates joint undertakings in tourism, and preserves subcontracting ties.
- Employment in Israel and worker remittances result in large initial increases in per-capita incomes; continuing access to Israeli labor markets provides ongoing employment opportunities for a growing Palestinian workforce.
- Relatively high increases in per-capita incomes minimize the need for donor assistance, other than for building infrastructure.

High-contiguity/low-integration scenario yields moderate economic growth:

- Low transaction costs and greater resources yield broad economic development, with growth in tourism, agriculture, and construction.
- Less-favorable access to Israeli product markets slows export growth, hurting manufacturing.
- Restricted access to Israeli labor markets reduces growth in incomes and employment.
- Most external assistance is needed in the short term to build and repair infrastructure, thereby creating conditions needed to attract foreign investment and increase exports to markets other than Israel.

Low-contiguity/high-integration scenario yields moderate economic growth:

- High transaction costs and fewer resources result in narrow economic development focusing primarily on services and construction.
- Access to Israeli goods markets facilitates exports and collaboration between Palestinian and Israeli firms.
- Access to Israeli labor markets fosters growth in per-capita incomes and helps to accommodate a growing Palestinian workforce.
- Relatively high per-capita incomes mean donor assistance can target building infrastructure.

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[25] All scenarios implicitly assume, however, that security and stability are maintained throughout the 2005 to 2019 period for economic development to occur as described.

Low-contiguity/low-integration scenario yields sluggish economic growth:

- High transaction costs and fewer resources result in narrow economic development.
- Less-favorable access to the Israeli market slows growth in exports, hurting manufacturing, but reducing the economy's vulnerability to border closures.
- Restricted access to Israeli labor markets reduces growth in incomes and employment, putting pressure on the domestic economy to accommodate more Palestinian workers.
- Significant donor aid is needed to build infrastructure and to combat poverty through a combination of social support and jobs programs.

Economic Implications of the Scenarios for a Future Palestinian State

The previous section described a series of scenarios, some of which provide a much better basis for sustained growth than others. A highly contiguous Palestine with access to Israeli product and labor markets is far more likely to enjoy rapid sustained growth than a fragmented Palestine cut off from the Israeli economy. In this section, we attempt to quantify the potential differences in economic growth and economic structure implicit in each scenario. For each scenario, we project growth in per-capita GDP and GNI. The differences in outcomes illustrate the economic implications of choices to be made by Palestinian and Israeli decisionmakers and the international community in final status negotiations.

Growth Accounting Model[26]

We estimate the implications of the scenarios for per-capita GDP and GNI by using a simple growth accounting model (see the appendix for details). The model ties growth in the labor force and employment, increases in the capital stock, and rates of growth in TFP to growth in per-capita GDP and GNI. The model is used to project per-capita GDP and GNI for the four scenarios for the 15 years following a final agreement and the establishment of a Palestinian state. We assume the time frame extends from the beginning of 2005 to the end of 2019. During this period, economic development in all four scenarios is assumed to move through three distinct phases:

- 2005–2009—recovery from the intifada and the creation of the foundations for longer-term growth
- 2010–2014—modernization of the economy and development of new economic sectors and markets
- 2015–2019—consolidation of gains and transition to self-sustaining growth.

[26] The dollar figures in this subsection are expressed in 2003 constant dollars.

Our model projects rather high annual Palestinian GDP growth rates under all scenarios, ranging from a high of about 20 to 23 percent in 2006 to a low of about 7 to 9 percent in 2019. Although the initial rates appear very high, they are consistent with the experiences of other post-conflict economies. In the first year of peace in Bosnia and Kosovo, GDP rose by three-fifths to two-thirds.[27] The projected rates are *feasible* according to our model. That is, if an independent Palestine achieved the increases in private-sector employment, capital stock, and TFP, these estimated GDP growth rates could ensue. The important questions for each scenario are: What do these GDP growth rates mean for Palestinian per-capita GNI, what private-sector employment growth is needed to drive this growth in GDP, and what is the magnitude of capital investment needed to achieve this GDP growth? We address these questions in turn.

Table 5.1 and Figure 5.2 illustrate per-capita GNI for the scenarios in milestone years. A peaceful, contiguous Palestine with close links to the Israeli economy (high contiguity and high integration) and sensible economic policies offers prospects for very rapid rates of growth. Under this scenario, our model projects per-capita GNI of $3,740 by 2019, over three times the estimated initial level of $1,110 at the end of 2004. Compared to the actual per-capita GNI of $1,890 in 1999, our model suggests that an independent Palestine could surpass pre-intifada levels within 5 years and essentially double per-capita income in 15 years.

Outcomes are not as favorable under the high-contiguity/low-integration scenario or the low-contiguity/high-integration scenarios with year-end per-capita GNI of $3,370, or 9 percent lower. In the first instance, per-capita GNI is lower throughout the entire time period because of limited employment in Israel. In the second, the higher transaction costs involved in doing business in a fragmented state result in slower rates of growth in per-capita GNI.

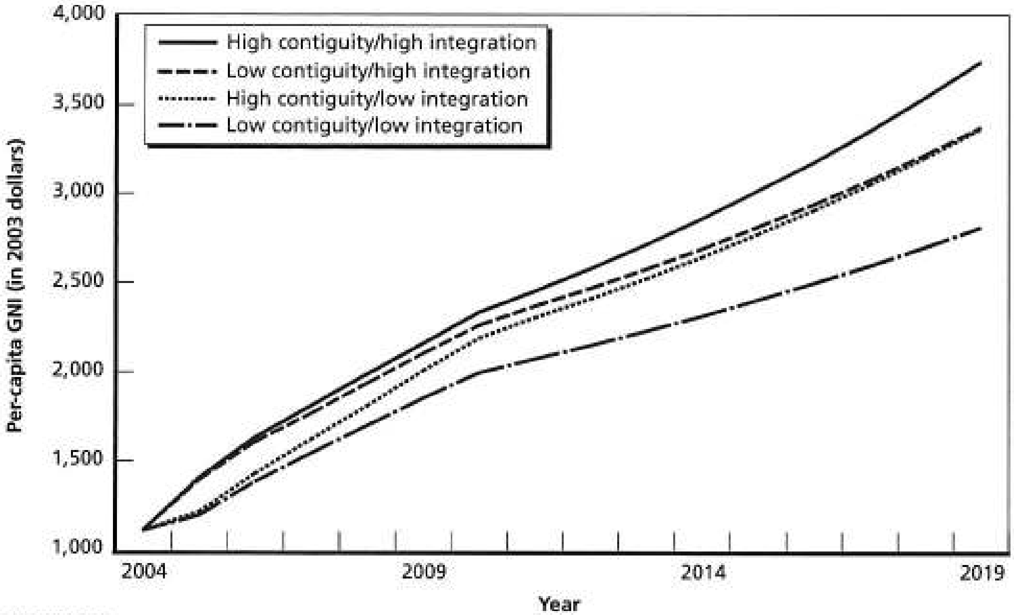
The low-contiguity/low-integration scenario yields the smallest per-capita GNI of all cases, increasing from $1,110 in 2004 to only $2,810 by 2019 or 25 percent lower than the high-contiguity and high-integration case.

Table 5.1
Estimated Palestinian Per-Capita GNI for 2004–2019 (under each scenario, in 2003 dollars)

Scenario	1999 Actual	2004 Estimate	2009 Estimate	2014 Estimate	2019 Estimate	1999–2019 % change
High contiguity/ high integration	$1,890	$1,110	$2,160	$2,860	$3,740	97.5%
High contiguity/ low integration	$1,890	$1,110	$2,000	$2,640	$3,370	77.6%
Low contiguity/ high integration	$1,890	$1,110	$2,100	$2,690	$3,370	78.0%
Low contiguity/ low integration	$1,890	$1,110	$1,850	$2,310	$2,810	48.3%

[27] Dobbins et al., 2003.

Figure 5.2
Estimated Palestinian Per-Capita GNI for 2004–2019



RAND MG146-5.2

What do these results suggest for the success of an independent Palestine? Although there is no generally accepted definition of what constitutes "success," a few simple criteria can provide some useful perspective. One criterion is whether per-capita incomes return to their pre-intifada levels within a reasonable time frame. Table 5.1 indicates that under every scenario but the low-contiguity/low-integration scenario, pre-intifada per-capita incomes of $1,890 are surpassed within five years. In the low-contiguity/low-integration scenario, however, the 2009 per-capita income of $1,850 indicates that pre-intifada levels are essentially only met.

A second criterion pertains to the long-term footing of the Palestinian state and its ability to recover from the setbacks of the last five years. We can gain insight by comparing the scenarios to a hypothetical Palestine that experienced no second intifada, but that instead saw slow and steady growth in real per-capita incomes between 1999 and 2019. As shown in Table 5.2, the turmoil in the period since the signing of the Oslo Accords provides little historical insight into what conservative, long-term trends in per-capita income for our hypothetical Palestine might look like; consequently we use annual real growth rates of 2 percent and 3 percent for comparison. Steady 2 percent growth from the 1999 base of $1,890 yields a per-capita income of $2,820 by 2019, whereas 3 percent growth yields a per-capita income of $3,420.

Table 5.1 suggests that every scenario but the low-contiguity/low-integration scenario would best both long-term trends by 2019. Thus, according to our model,

Table 5.2
Actual and Estimated Per-Capita GNI Real Growth Rates

Year	Per-Capita GNI Growth (actual)	Time Frame	Per-Capita GNI Growth (assumed)	Per-Capita GNI Growth (assumed)
1994	-4.9			
1995	-9.6			
1996	-9.0	1999–2019	2%	3%
1997	3.4			
1998	7.7			
1999	3.3			
1999 per-capita GNI	$1,890	2019 per-capita GNI	$2,820	$3,420

SOURCES: IMF, 2001, p. 5; and RAND Corporation calculations.

Palestine could potentially grow fast enough by 2019 to make up for the effects of the current intifada. The high-contiguity/high-integration scenario would result in per-capita income about 9 percent higher than that resulting from the 3 percent growth trend. The high-contiguity/low-integration and low-contiguity/high-integration scenarios would yield per-capita income more in line with the 3 percent trend. However, the low-contiguity/low-integration scenario fares less well than the 3 percent trend, and only slightly better than the 2 percent trend.

A third criterion is how well Palestine performs relative to other countries. The World Bank ranks countries by their income levels into one of four categories: lower income (per-capita GNI of $765 or less), lower-middle income ($766 to $3,035), upper-middle income ($3,036 to $9,385), and upper income ($9,386 or above). Palestine's per-capita income of $1,890 in 1999 puts it solidly in the ranks of lower-middle-income countries. But Table 5.1 indicates that Palestine would become an upper-middle-income country by 2019 in three of the four scenarios. In the low-contiguity/low-integration scenario, Palestine would remain a lower-middle-income country although it would be toward the higher end of the range.

Table 5.3 presents the employment projections from the model with respect to potential growth in domestic private-sector employment. It illustrates the average annual increases in private-sector jobs that would be needed to reduce the Palestinian unemployment rate to around 8 percent. The model results show that domestic private employment would have to grow at very rapid rates for this reduction to occur.

Under the high-integration scenarios, domestic private employment would have to grow at an annual average of about 56,400 jobs from 2005 to 2009, or at 15.2 percent per year. This would be followed by more moderate employment growth of 41,100 jobs annually (6.5 percent) from 2010 to 2014, and 46,800 jobs annually (5.5 percent) from 2015 to 2019, yielding an unemployment rate of about 8.2 percent in 2019.

Table 5.3
Estimated Annual Average Domestic Private-Sector Job Growth Needed for Given Unemployment Reduction (under high- and low-integration scenarios)

	2005–2009 Annual Average Private-Sector Job Growth		2010–2014 Annual Average Private-Sector Job Growth		2015–2019 Annual Average Private-Sector Job Growth		Estimated Unemployment Rate	
Scenario	Number of Jobs	Growth Rate (%)	Number of Jobs	Growth Rate (%)	Number of Jobs	Growth Rate (%)	2004 (%)	2019 (%)
High integration	56,400	15.2	41,100	6.5	46,800	5.5	42.8	8.2
Low integration	66,500	17.2	47,900	6.9	52,000	5.5	42.8	8.1

For the low-integration scenarios, domestic private employment would have to grow by about 66,500 jobs per year between 2005 and 2009, or a 17.2 percent annual average growth rate. This is 10,000 jobs per year more than in the high-integration scenarios. More rapid job growth is needed to compensate for lower employment in Israel under low integration. Under these low-integration scenarios, employment growth would moderate to 47,900 jobs annually (6.9 percent) between 2010 and 2014, and 52,000 jobs annually (5.5 percent) between 2015 and 2019. This would yield an unemployment rate of about 8.1 percent in 2019.[28]

Achieving these increases in employment would be a considerable challenge for an independent Palestine. Job growth would have to be even stronger if a large number of refugees were to resettle in the new state. The historical record does not make us optimistic that these rates of employment creation could be achieved: The highest rate of growth in private-sector employment recorded since the signing of the Oslo Accords was only 7 to 8 percent. This employment growth took place in 1998–1999, following a sharp reduction in security restrictions and closures. We could certainly expect rapid increases in employment as the state is inaugurated and constraints on trade and commerce are lifted. But economic growth and investment will have to be very substantial to ensure that high rates of growth are maintained over time.

If Palestine is able to achieve these initial increases in private-sector employment, the prospects rise for achieving growth in per-capita incomes substantial enough to make a very real impact on living standards. However, prospects of employment growth of this magnitude in the low-contiguity/low-integration scenario are poor. Private-sector job growth will be more difficult under this scenario because the state has less control over resources and transactions costs are high. As a consequence, growth in per-capita incomes will suffer.

[28] One reason, though not the primary one, why these private-sector growth rates need to be this high is because our model deliberately limits employment growth in the Palestinian public sector to 1 to 2 percent a year. As mentioned earlier, PA employment is already quite high, even by regional standards. High public-sector employment in other Arab countries has contributed to slow rates of growth in private-sector business formation and in TFP because government bureaucracies stifle the creation of new businesses and slow productivity growth through the imposition of regulations designed to extort bribes.

Next we calculate the magnitude of capital investment needed to reach pre-intifada per-capita GNI by 2009 and to effectively double it (in most cases) by 2019. These calculations depend noticeably on the value of the existing Palestinian capital stock, but precise estimates of the capital stock do not exist particularly because of the damage during the intifada. We expect the capital stock to total about $12.1 billion in 2004 (see the appendix for details). Accordingly, we calculate capital stock growth and depreciation in each scenario beginning from this base.

Table 5.4 illustrates the investments in capital stock needed to attain the rates of growth posited in the scenarios over different time periods. Our model indicates that investment in capital stock of $28.7 billion in the ten-year time frame from 2005 to 2014 and $49.9 billion over the 2005–2019 time frame to generate the incomes illustrated in Table 5.1. In other words, investments averaging about $3.3 billion a year would be needed to create a capital stock sufficient to generate per-capita GNI of $3,370 by 2019 under the high-contiguity/low-integration scenario. We have assumed that the volume of investment would rise over time, from $2.6 billion per year for 2005–2009 to $4.2 billion in 2015–2019.

These projections are for total gross fixed capital investment, private and public, in a new Palestinian state needed to generate the posited levels of employment. The investment needed would be higher if a substantial number of refugees resettled in Palestine and additional employment would be necessary. These estimates are totals financed by all sources: domestic savings, direct foreign investment, private borrowing from abroad, loans to the state, and foreign assistance. The international community is not assumed to provide all of this investment. However, it is likely that initially virtually all public-sector and some private-sector investment would be funded by foreign donors. Most of this funding would need to be frontloaded during the 2005–2009 time period so as to create the infrastructure that will be needed for sustained economic growth in Palestinian per-capita incomes. By 2019 most investment would be undertaken by the private sector or financed through tax revenues collected by the Palestinian government.

These levels of investment, although large, are not extraordinarily different from investments and assistance flows provided to Bosnia during the first years following the Dayton Accords. They also are not an estimate of the levels of foreign assistance a new Palestinian state might need. Even at the onset of the new state, Palestinians will be investing their own funds in homes and businesses. As the Palestinian economy gains

Table 5.4
Estimated Palestinian Capital Stock Investment Required in 2005–2019 (under each scenario, in billions of 2003 dollars)

	2005–2009 Total	2005–2009 Average	2010–2014 Total	2010–2014 Average	2015–2019 Total	2015–2019 Average	2005–2019 Total	2005–2019 Average
Each scenario	$13.1	$2.6	$15.7	$3.1	$21.2	$4.2	$49.9	$3.3

NOTE: The five-year totals do not sum to the 15-year totals because of rounding.

its legs, a rising share of this investment will be financed domestically or through direct foreign investment, easing the burden on the international donor community.

The rate of return on this investment is substantially lower for the low-contiguity/low-integration scenario than for the others. An investment of $50 billion between 2005 and 2019 results in Palestinian per-capita GNI of only $2,810 by 2019 in this case. By contrast, the same investment (all else being equal) results in a per-capita GNI of at least $3,370 by 2019 for any of the other three scenarios. According to our model, decision-makers considering the initial conditions for a Palestinian state would be well advised to ensure that Palestine is economically integrated with Israel or provided sufficient contiguity to avoid this suboptimal scenario.

Limitations of the Growth Accounting Model

To some extent the growth accounting model fails to capture the true costs in lower economic output of a noncontiguous Palestinian state. The costs to Palestinian businesses of border closures have been substantial. Even assuming relatively free flows of goods and people among Palestinian territories, if most internal transactions in Palestine entail one or more security checks or border crossings, the increased cost of doing business will throttle growth. This lost economic output cannot be readily measured, but the very sharp declines in per-capita incomes in the West Bank and Gaza over the course of the second intifada illustrate the challenges a noncontiguous state would face.

By the same token, it is difficult to capture in a growth accounting framework the multiplier effects on domestic incomes of wages earned in Israel. The two labor markets are quite complementary: Israel primarily needs less-skilled labor; the West Bank and Gaza has a surplus of less-skilled labor. Demand for well-educated labor such as doctors and engineers is much higher in the West Bank and Gaza.

Within growth accounting models, inputs are fungible: for example, increases in capital can offset slower rates of productivity growth. Although true in a modeling framework, the empirical evidence does not necessarily support this assumption. International assistance programs suggest that unless the institutional arrangements and incentives are present and the necessary human capital available, no amount of investment in physical capital can generate sustained growth. Thus unless the Palestinian government designs and implements the necessary institutional framework and the accompanying controls, sustained growth likely will not materialize. Moreover, growth will not materialize without peace. As demonstrated by Iraq, throwing massive amounts of money at an economy will not generate sustained economic growth in an environment of violence. Although both assumptions are implicit in this model, it bears remembering that good governance and a secure environment are likely to be quite important for economic growth.

Potential Inflows of Foreign Assistance

Virtually all economies, even fairly poor ones, finance most investment from domestic savings. The construction of housing, purchases of motor vehicles, and investments in

small businesses all tend to be financed from personal savings. For countries with large expatriate populations, remittances form another important source of investment. Remittances tend to flow into the same types of investments as domestic savings. International borrowing, especially from international financial institutions like the World Bank and from the regional development banks, and foreign assistance that is used for investment are heavily skewed toward public-sector investment. In contrast, foreign direct investment flows to the private productive sector. It is concentrated in sectors such as manufacturing, telecommunications, transport, wholesaling, retailing, and financial services.

The growth accounting model employed above does not distinguish among the sources or destinations of investment. A successful Palestinian state will need to invest in all sectors of the economy and will draw on all sources of investment. However, we believe it is useful to compare the size of these aggregate flows of investment to potential inflows of foreign assistance. Although Palestine will not be able to rely on foreign assistance for all investment, an appreciable share of public investment, especially in the early years, will have to come from international financial institutions or foreign donors. Only after a few years of peace and economic growth and a track record of financial probity will a Palestinian government be able to borrow from commercial lenders.

To roughly size the magnitude of assistance that might become available, we apply average per-capita levels of assistance that went to Bosnia and Kosovo in the first two years of reconstruction to the projected Palestinian population through 2014 to size future levels of assistance analogous to those received by those two entities. We believe the analogies are appropriate. Like the West Bank and Gaza, these two entities suffered considerable damage from conflicts. Both have attracted considerable international interest and assistance. Both have had some success in creating democratic governments and revitalizing the local economies. The entities are somewhat similar in size of population: Bosnia has a population of 4 million; Kosovo, 2.3 million; and the West Bank and Gaza, 3.5 million.

In the first two years following the signing of peace accords in Bosnia and Kosovo, foreign assistance (grants and loans) averaged $714 and $433, respectively, per person per year. Applying these per-capita figures to the projected population of the West Bank and Gaza, an analogous inflow of assistance would run $1.6 billion to $2.7 billion in the first years after the creation of a state, rising to $2.1 to $3.5 billion by 2014 as a result of increases in population (see Table 5.5). Over the ten-year period between 2005 and 2014, flows of foreign assistance to a new Palestine state analogous with those that have been granted Kosovo and Bosnia would run from $18.8 billion to $31.1 billion.

By way of comparison, the World Bank estimated that the total volume of international aid to the West Bank and Gaza was $1,051 million in 2002 and $929 million in 2001; the World Bank reported that the 2001 level represented twice the annual volume of aid prior to the second intifada. Thus aid based on the Kosovo analogy

Table 5.5
Aid Flows Analogous to Those for Bosnia and Kosovo

		Total Aid (in millions of 2003 dollars)	
Year	Palestinian Population	Bosnia Analogy	Kosovo Analogy
2005	3,761,904	$2,688	$1,627
2006	3,889,249	$2,779	$1,683
2007	4,018,332	$2,871	$1,738
2008	4,149,173	$2,964	$1,795
2009	4,281,766	$3,059	$1,852
2010	4,416,076	$3,155	$1,910
2011	4,547,678	$3,249	$1,967
2012	4,676,579	$3,341	$2,023
2013	4,807,137	$3,434	$2,080
2014	4,939,223	$3,529	$2,137
Total	—	$31,068	$18,813

would represent a further 50 percent increase for 2005, relative to the 2002 level of international aid to the West Bank and Gaza, while aid based on the Bosnia analogy would require more than doubling the level of aid received in 2002.

These numbers based on the Kosovo analogy fit comfortably within the projections of the investment needed to rapidly reduce unemployment in Palestine. Those based on the Bosnia analogy exceed the investment projected to be necessary. However, a sizable share of foreign assistance will be used to pay for recurring costs, especially during the first years of the new nation's existence, before tax systems are in place and economic growth provides additional resources that are easier to tax. Thus, per-capita assistance levels such as those provided to Bosnia might be effectively utilized. In any event, the numbers suggest that the challenge facing the international donor community is on the order of the challenges presented by Bosnia and Kosovo. Aid flows exceeding the levels given Bosnia would very likely be difficult for the nascent state to absorb; levels below those provided Kosovo might fail to spur the economic growth that we believe is necessary to make the new state a success.

Best-Practice Economic Policies for Stimulating Economic Growth

Whatever configuration an independent Palestine takes, the Palestinian government in conjunction with external actors—including Israel, other foreign governments, and international financial institutions—will make economic policy decisions that will affect Palestinian development and growth in per-capita incomes. In many instances, some economic policies are clearly superior to others in terms of stimulating economic growth, increasing incomes, and reducing poverty. Below, we provide a menu of best-practice economic policies that would accelerate improvements in economic welfare in a future Palestine.

We have grouped what we see as the key policy options into the following categories:

- fostering free trade
- partnering with neighboring countries
- investing in infrastructure
- easing Palestinian employment in Israel
- expanding access to capital
- choosing currencies
- improving the business climate
- investing in human capital.

Fostering Free Trade

Palestine's key comparative advantage in international trade is its human capital. Thus, regardless of whether or not Palestine retains preferential trade access to Israel, a Palestinian government would maximize gains from trade by making labor-intensive commercial activities located in Palestine as competitive as possible. This could be done through appropriate infrastructure investments (described below) and trade policies.

Competitiveness implies that exporters will not be burdened with paying duties on imported raw materials and components. It suggests that products move swiftly and securely through ports. And it implies that the sources of inputs for Palestinian goods and the destinations for its exports be increased.

We recommend the following:

- Upon achieving statehood, a Palestinian government should adopt a zero- or low-tariff policy, especially for industrial inputs.
- It should also ensure that transshipment costs, customs duties, and customs procedures are as swift, secure, and cheap as possible.
- A Palestinian government should negotiate free trade agreements with as many countries as possible, especially its immediate neighbors (Israel, Jordan, and Egypt), its other Arab neighbors, and other important trade partners such as the United States and the European Union.
- To foster economic growth in Palestine, the Israeli government should provide duty-free access to Palestinian exports. Israel should also encourage Palestine to provide duty-free access to imports from Israel so as to keep Palestinian exporters competitive by ensuring that imported raw materials and components are competitively priced.
- The United States and the European Union should extend current free trade agreements with Israel and Jordan to Palestine.
- Arab states should provide duty-free access to imports from Palestine.

Partnering with Neighboring Countries

Palestine should work with its neighbors to coordinate the development of specific economic sectors. Some sectors would clearly be stronger if multiple countries worked